



## Special Series on Central Bank Law Design Issues to Respond to COVID-19

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# Central Bank Exceptional Measures in the COVID-19 Crisis: Key Legal Design Issues

This note<sup>1</sup> discusses key legal design issues of the exceptional measures adopted by central banks in response to the COVID-19 pandemic. From a legal perspective, clear yet flexible legal mandates should grant central banks sufficiently broad powers, authorizing a wide range of generally appropriate financial transactions. Risks (that is, autonomy, reputational, legal, and financial risk) stemming from exceptional measures can be mitigated by legal design choices. Although central bank laws should generally prohibit or strictly limit monetary financing of the public sector, a statutory “escape clause” could be designed to allow central banks to provide—under specific conditions—limited funding to the government in unexpected and severe emergency situations. For exceptional measures that go beyond core central bank tasks, the legal framework should safeguard the central bank’s financial autonomy, including for “solvency support” to failing systemic financial institutions.

### CENTRAL BANKS HAVE TAKEN A BROAD RANGE OF EXCEPTIONAL MEASURES

To respond to the COVID-19 crisis, central banks around the world have adopted a range of exceptional measures to provide liquidity to the financial systems, support the State’s financing mechanisms, and keep more broadly funding markets open. To complement the expansion of the standard monetary policy toolkit (for example, longer repos), central banks can choose from a broad menu to inject systemic liquidity and support funding markets: (1) FX credit in the form of swaps<sup>2</sup> to local banks and sometimes even firms, (2) securities lending operations to increase the availability of high-quality collateral, (3) the acquisition of financial securities (for example, corporate bonds, units in bond mutual funds) other than government debt securities, and (4) special facilities to support vulnerable market segments (for example, commercial paper and municipal discount paper). To support the State’s financing mechanisms and the orderly functioning of the markets to help respond to the COVID-19 shock, some central banks have considered temporary direct advances to the State, as a

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<sup>2</sup> The Federal Reserve and the ECB have supported the cross-border availability of respectively US dollars and euros to selected other central banks by swap lines and repurchase facilities.

complement to market-based financing (see, for example, the Bank of England with its “Ways and Means Facility”).

## EXCEPTIONAL MEASURES MUST BE LEGALLY GROUNDED IN THE CENTRAL BANK’S MANDATE

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The Communique of G20 Finance Ministers and Central Bank Governors of April 15, 2020, notes that central banks have taken “immediate and exceptional measures” in response to the COVID-19 pandemic, “including the deployment and expansion of bilateral swap lines and the introduction of repo facilities by central banks in line with their mandates.” This is an important statement, as central banks are public institutions that have been allocated a specific legal mandate for which they are accountable. In the absence of a clear and robust legal mandate, central banks will likely be exposed to legal and political challenges, as well as attempts to curtail their autonomy. The conceptual components of a central bank legal mandate are summarized in Box 1.

### Box 1. Legal Mandates of Central Banks: The Concept

A central bank’s mandate consists of three interlinked legal aspects: its objectives, functions, and powers. These three legal aspects are always enshrined in central bank laws, albeit sometimes under different labels.

Central bank *objectives* are the goals that a central bank is legally required to pursue by exercising its activities. The objectives commonly include the achievement and maintenance of price stability, contributing to financial stability, and supporting the government’s general economic policies. Central bank laws often establish a hierarchy among these objectives.

Central bank *functions* are the tasks that a central bank is legally entrusted with to achieve its objectives. Examples of core central bank functions are the definition and implementation of monetary policy, the management of the official foreign reserves, and the issuance of currency.

The concept of *powers* finally refers to specific legal powers that enable a central bank to implement its functions. These powers include the authorization to open accounts for counterparties, to purchase or sell outright securities, and to enter into collateralized (“Lombard”) lending and repurchase agreements with counterparties.

It is noted that central bank statutory objectives and functions vary across central banks, including in function of their stages of economic and institutional development.

Central bank mandates should be broad enough to enable central banks to effectively manage an economic-financial crisis.<sup>3</sup> (This is valid for all central banks, including those within a monetary union.) The measures adopted by central banks to address crises do not raise any particular legal concerns about the central banks’ functions. As for central banks’ objectives, the need to preserve the effectiveness of the monetary transmission mechanism in a crisis and ensuring financial stability are complementary sine qua nons for the objectives of

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<sup>3</sup> A central bank’s macro-prudential function, with the appropriate instruments (including the monitoring of the financial system, appropriate stress testing, and comprehensive macroprudential toolkits) helps to minimize the risk and severity of such crisis: the higher the effectiveness of macro-prudential instruments during normal times, the more likely this is to help in effective responses during crisis times.

ensuring price stability and contributing to financial stability, which can hence both be used to justify exceptional measures.<sup>4,5</sup>

Central bank laws typically include one or more “powers provisions” authorizing the central bank to enter into financial transactions. Some central bank laws include a single such provision, listing all private law powers of the central bank in a single provision. Other central bank laws feature various such provisions spread out throughout the law. From a formal perspective, both approaches are legally sound.

Most of those “powers provisions” include powers to (1) enter into the standard Lombard loan and repurchase agreements with banks and (2) acquire high-quality assets, in particular government debt securities, debt securities of foreign governments, and gold. In addition, in order to allow their central banks to react in a flexible manner to developments in financial markets, central bank Boards of Directors/Executive Boards are often granted some degree of discretion in determining how to deploy those powers.

However, many of those “powers provisions” lack authorizations for other financial transactions, financial assets, and contracting with nonfinancial counterparties. All of these may be useful in a crisis. From a policy perspective, it may be appropriate to limit under normal circumstances the type of assets a central bank can transact in and the types of counterparties that can enter into authorized transactions.<sup>6</sup> For instance, it is well understood that central banks should execute their financing-based monetary policy operations (Lombard loans and repurchase agreements) with solvent banks only. However, from a legal perspective, limiting those assets and counterparties in law is not necessarily the optimal choice, as an overly restrictive approach in this respect will hamper central bank flexibility in the face of a crisis.

These restrictions can be overcome by targeted reform to central bank laws that introduces and combines the following two legal techniques:

### Sufficiently Broad “Powers Provision”

First, central bank laws need to include a sufficiently broad “powers provision,” authorizing a wide gamut of generally appropriate financial transactions. From a legal perspective, such a “powers provision” has three dimensions and each of these dimensions may require reform to support the exceptional measures.

- **Authorized Transactions:** In addition to authorizing the standard outright sales and purchases, repurchase agreements and Lombard loans, central bank laws should also include authorizations for the conduct of, as a minimum, (1) swaps and other derivative transactions; and (2) securities lending transactions. Other useful transactions could also be considered, such as “gold loans.” One option is to add to the list of authorized transactions the open category of “typical financial transactions of (central) banks.”<sup>7</sup> Another

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<sup>4</sup> For example, Article 2 of the ESCB/ECB Statute defines the ESCB’s primary objective as *maintaining price stability*, whereas Section 18 of the Bank of Canada Act provides that: “(ii) if the Governor is of the opinion that there is a *severe and unusual stress on a financial market or the financial system*, buy and sell from or to any person any securities and any other financial instruments, to the extent determined necessary by the Governor.”

<sup>5</sup> “Banks and capital markets are not simply different forms of finance; they are joined at the hip. Banks rely on markets for their funding and as an income source. Markets rely on banks in their capacity as market-makers and arrangers of transactions, for funding and above all, for backup credit facilities. As such banks and capital markets complement each other, especially in times of stress.” See BIS. 2020. *Annual Economic Report*. p. 46.

<sup>6</sup> Importantly, many central bank laws include such limitations for some types of transactions (for example, Lombard loans) and not for others (for example, outright sales and purchases).

<sup>7</sup> See, for example, Section 23(1)(r) of the Monetary Authority of Singapore Act, which allows the MAS to “do generally all such things as may be commonly done by bankers and are not inconsistent with the exercise of its powers or the discharge

option is to grant the central bank “all the powers necessary or incidental in carrying out its functions,” which is a slightly broader approach.

- **Authorized Assets that can be subject to Transactions:** Authorized assets will be used as collateral for lending operations, or as part of outright (or repurchase) sales and purchases transactions. Rather than only authorizing transactions in the standard high-quality assets (government debt securities, debt securities of foreign governments, and gold), the central bank law should more broadly allow transactions in financial instruments, precious metals and foreign currency. This broad category would cover for instance corporate debt securities and ETF. Moreover, well drafted provisions should provide maximum flexibility on the interaction between assets and transactions. For instance, if Lombard loans and repurchase transactions currently are only allowed for government debt securities, broadening their scope would allow to bring other assets (gold, credit claims) under these transactions.
- **Authorized Counterparties:** Rather than only authorizing transactions with a closed category of counterparties listed in the law, the central bank law should be open and grant the central bank the functional autonomy to select its types of counterparties, in light of the nature of the transaction and broader circumstances.<sup>8</sup> In times of crisis, this would allow designing transactions with Special Purpose Vehicles and corporates. This does not imply that central banks *should* transact with those entities, but merely that the central bank law does not prevent them from doing so, when and if deemed necessary by the central bank in light of circumstances.

Restrictions in this respect should in principle be limited to cases where there is a high risk or history of abuse, such as quasi-fiscal activities. However, even this risk should primarily be mitigated by sound governance mechanisms, including transparency,<sup>9</sup> accountability and objective criteria to prevent inappropriate discrimination of certain institutions or assets.

## “Guided” Flexibility for the Central Bank Board

Second, the central bank law should authorize the competent Board of the central bank to flexibly determine its eligible counterparties and assets. For some central banks, this decision will accrue to the Board of Directors, in others to the Executive Board, and in others even to the Monetary Policy Committee.<sup>10</sup>

Such an approach would allow the competent Board to determine the eligible assets and counterparties in secondary legal instruments (policy decision, regulation). Doing so will make the eligible assets and counterparties more a matter of policy and less of law.<sup>11</sup> This would, in turn, enable the central bank to react in a

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of its duties under this Act.” Article 4(B)15 of the Central Bank of Jordan Law enables the central bank to “carry out any other functions and transactions normally performed by central banks (...).”

<sup>8</sup> For example, Article 36 (5) of the Bank of Israel Law, 5770-2010 (as amended) gives the Bank of Israel the discretion: “*under exceptional circumstances, when the Committee is of the opinion that there exists a genuine threat to the stability or orderly activity of the financial system - grant credit to Financial Entities that are not Banking Corporations, under conditions the Committee determines.*”

<sup>9</sup> The IMF has recently adopted a Central Bank Transparency Code that replaces the Monetary and Financial Policies Transparency Code of 1999. Principle 3.1 of the Code provides that the “central bank discloses its operational framework with a well-defined operational target, objective, instruments, collateral and access criteria.”

<sup>10</sup> On central bank Boards: see Bossu, W., and A. Rossi. 2019. “*The Role of Board Oversight in Central Bank Governance: Key Legal Design Issues.*” IMF Working Paper WP/19/293.

<sup>11</sup> IMF. 2020. “Central Bank Support to Financial Markets in the Coronavirus Pandemic.” Special Series on Financial Policies to Respond to COVID-19, p. 5, lists the operational parameters for eligible counterparties, assets, and collateral. The criteria

flexible manner to developments in the monetary-financial system, by being more restrictive in normal times and more open in exceptional circumstances. Naturally, such a flexibility underscores the importance of a sufficient level of autonomy of the competent Board vis-à-vis the government and private interests.

While flexibility might be very useful from an operational and policy perspective, the central bank Board should be mindful of the risk that such flexibility also might raise challenges (for example, excessive reliance (“moral hazard”) by market participants in their risk management on the probability of future exceptional central bank operations) for the central bank. This risk could be mitigated by the introduction of broad parameters in the central bank law to guide this flexibility. For instance, the central bank law could prohibit uncollateralized lending and require that lending operations in principle be undertaken with solvent counterparties only (on solvency support: see below). Also, to the extent applicable, the principle of equal treatment (that is, comparable situations must not be treated differently, and different situations must not be treated in the same manner unless objectively justified) should inform the flexible approach to the determination of eligible counterparties and assets.

Box 2 provides a legislative example of how those two legal techniques can be combined into a single broad statutory “powers provision.”

### **Box 2. Example of a Broad Legal Powers Provision**

Article xx: In order to achieve its objectives and to carry out its functions, the Central Bank is authorized to enter into the following financial transactions:

- 1) Open cash and securities accounts in its books and receive moneys, securities and precious metals in deposit;
- 2) Open cash and securities accounts in the books of counterparties and deposit moneys, securities and precious metals;
- 3) Purchase and sell outright or under repurchase agreement financial instruments, precious metals and other financial assets, denominated in domestic or foreign currency;
- 4) Purchase and sell (spot and forward) domestic and foreign currencies;
- 5) Conclude swaps and other derivative transactions;
- 6) Provide credit to solvent counterparties based on adequate collateral;
- 7) Issue debt instruments;
- 8) Carry out transactions with a view to the investment and financial management of its holdings of foreign currencies and of other official foreign reserve elements; and
- 9) Enter into other financial transactions that are conducive or incidental to performing its functions.

The Board of Directors shall specify in a published [regulation/policy decision] the eligible counterparties, financial instruments, assets and collateral subject to the financial transactions of the central bank.

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for determining asset eligibility should, inter alia address the need for legal certainty regarding the requirements for the attachment and perfection of a security interest for repayment obligations, and the enforcement of such collateral in the event of a counterparty's default.

## EXCEPTIONAL MEASURES CAN LEGALLY BE DESIGNED TO PROTECT THE CENTRAL BANK'S FINANCIAL AUTONOMY AND MANAGE RISKS

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Legally, several of the instruments used in exceptional measures are not necessarily fundamentally different from those used in standard operations.<sup>12</sup> Collateralized lending and outright purchases of financial instruments, for instance, also feature in the toolkit of conventional monetary policy operations and official foreign reserve assets management.

However, the “financial risk” of exceptional measures will typically be higher than that of standard operations. On the one hand, the amounts exposed to a potential loss are much higher than for standard operations. On the other hand, the probability of a loss is higher due to the broader range of assets and counterparties. Irrespective of their legal features, seen from an economic policy perspective, conventional monetary policy operations, expanded monetary policy operations, unconventional monetary policy operations, and exceptional crisis measures lie indeed on a spectrum towards ever higher risk.

This problem is exacerbated by that fact that some exceptional measures could be considered to take place in the “twilight zone” between monetary policy and quasi-fiscal operations.<sup>13</sup> Specifically, while those measures are aimed at injecting liquidity in the financial system, they are also directed to nonfinancial recipients, which do not typically play a role in monetary policy transmission. By consequence, the higher risks discussed above are carried by the central bank in the context of what could be considered as a non-monetary activity. Financial losses caused by such measures could put in question the financial autonomy of the central bank.

This is also illustrated by the fact that various exceptional measures have been adopted in consultation with governments. While policy coordination between the government and central bank is indeed important in the context of crisis management, a balance needs to be struck between the need to maintain central bank autonomy and government involvement, as well as the associated risks.

The legal framework should mitigate this problem by designing exceptional measures in a manner that protects the central bank's financial and broader autonomy. More specifically, when designing the legal framework for quasi-fiscal exceptional measures, policy makers can consider two legal techniques to shift the main financial risk of these measures to the State and thus protect the autonomy and financial soundness of the central bank:

- One option is to provide an explicit State guarantee for the central bank's exceptional lending operations.<sup>14</sup>
- Another option is to implement the exceptional measures through separate legal structures, such as defining the central bank as the Ministry of Finance's agent and creating a subsidiary or a Special Purpose Vehicle, separate from the central bank's balance sheet, combined with equity injections by the State.<sup>15</sup>

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<sup>12</sup> CGFS Papers No. 63, October 2019, *Unconventional Monetary Policy Tools: A Cross-country Analysis*, Report prepared by a Working Group chaired by S. Potter (Federal Reserve Bank of New York) and F. Smets (ECB).

<sup>13</sup> Central banks' quasi-fiscal operations can affect the overall public sector balance without affecting the budget as conventionally measured. These operations increase the effective size of the public sector and have reputational and financial risks for the central bank. See IMF. 1996. “Quasi-fiscal Operations of Public Financial Institutions.” Occasional Paper No. 142.

<sup>14</sup> The guarantee can be provided to the central bank or to the banks which on-lend the central bank credit: the latter option was chosen in the South African COVID-19 Loan Guarantee Scheme.

<sup>15</sup> Special purpose vehicle structures could pose specific challenges and have longer-term implications, as divesting from them could prove difficult beyond the crisis duration.

Several countries have carefully distinguished between central bank and fiscal roles by structures through which the State takes the main financial risk of some of the exceptional measures. Examples include some of the Federal Reserve's lending programs<sup>16</sup> with equity injections by the US Treasury's Exchange Stabilization Fund; the UK's Covid Corporate Financing Facility; and, with a role for the private sector, the Thai Corporate Bond Stabilization Fund.

As the State assumes the financial risk, the government will also likely have the final say on the adoption of such measures.<sup>17</sup> However, the central bank should *implement* the exceptional measure in an autonomous manner, without political interference.

Another risk-mitigating element would be to design the exceptional measures in such way that they are limited to the catastrophic events causing a severe funding market disruption. Legally, this could be achieved for instance by a carefully designed scope of a facility and clarified in the recitals of the legal documentation.

Finally, quasi-fiscal exceptional measures may also give rise to specific reputational and legal risks. For instance, if engaged in buying bonds of industrial and commercial firms, the central bank will need to be able to demonstrate that it treats comparable firms equally, lest it be accused of "choosing winners and losers." This will certainly require increased transparency and accountability.<sup>18</sup> Appropriate legal design features of exceptional measures can also mitigate risks. For instance, the legal instrument (decision, regulation, contractual agreement) establishing an exceptional measure could (1) confirm the temporary nature of such a measure (for example in the form of "sunset clauses"<sup>19</sup>), (2) define clear triggers for financial transactions, and (3) clearly define the eligible assets and counterparts in an objective and transparent manner.

## SPECIFIC LEGAL DESIGN PRINCIPLES FOR MONETARY FINANCING BY A CENTRAL BANK

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In general, it is not good practice for a central bank to finance the public sector—whether in the form of loans, advances, or the purchase of government debt securities on the primary market. The reason is that such monetary financing could lead to "fiscal dominance" and thus impede the central bank from achieving its objective of price stability. Also, such financing reduces the incentives for fiscal discipline. This is why many central bank laws prohibit monetary financing, or strictly curtail it.

Nevertheless, exceptions to the prohibitions or limitations of monetary financing could be considered to allow the central bank to provide funding directly to the government in severe emergency circumstances. This would be different from secondary market purchases of government securities to maintain price and financial stability.

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<sup>16</sup> For instance, the Federal Reserve's Main Street Lending Program, which enabled the Federal Reserve Bank of Boston to temporarily support lending to small- and medium-sized businesses that were in sound financial condition prior to the onset of the COVID-19 pandemic.

<sup>17</sup> In the United States, the special programs designed by the Federal Reserve "in urgent and exigent circumstances" under Section 13.3 of the Federal Reserve Act require the prior approval of the Secretary of the Treasury (see subsection iv).

<sup>18</sup> The inclusion of certain specific transparency and accountability requirements (for example, a specific audit) in the legal framework for exceptional measures can be very useful in this regard.

<sup>19</sup> See, for example, the ECB Decision (EU) 2020/440 (ECB/2020/17) that establishes the Pandemic Emergency Purchase Program (PEPP). PEPP is an asset purchase program of private and public sector securities. In July 2020, the ECB increased the overall envelope of the PEPP and extended the horizon of net purchases "until at least the end of June 2021, or beyond, if necessary, and in any event until the Governing Council considers that the COVID-19 crisis phase is over" (see Recital 4).



Specifically, an appropriate statutory “escape clause” could be designed to be triggered in severe emergency circumstances, but with restrictions on monetary financing in normal times. Such a clause could act as an ex ante institutional mechanism for the central bank’s role of emergency lender to the State, while ensuring adherence to the rule of law. Some countries already have a form of “escape clause,” see Box 3.

### **Box 3. Temporary Monetary Financing in Emergency Situations: Country Examples**

In some countries, separate emergency legislation authorizes the central bank to finance exceptionally the State in case of a clear and severe emergency. For example, in the Netherlands, the Emergency Law on Financial Transactions<sup>20</sup>—which has not been used—allows the Government, following a recommendation by the Prime Minister, to declare a financial emergency (formally this is done by way of a Royal Decree). Such a Royal Decree must be proportional and necessary to address a clear and present emergency. In addition, the Royal Decree must be submitted promptly to Parliament for approval; in other words, it is subject to democratic control. Following such a declaration, a provision of this Law, which is not yet in force (but depends on a Royal Decree), can require De Nederlandsche Bank (DNB) to provide temporary unlimited credit or advances to the State according to the terms and conditions determined by the Minister in consultation with DNB.

In other countries, the central bank law itself includes an “escape clause.” For instance, the Organic Law of the Central Bank of Chile fully prohibits any type of monetary financing to the State, but contains an escape clause that establishes that only in the event of foreign war or threat of foreign war, determined by a secret resolution of the National Security Council, the Central Bank may obtain, grant, or fund credits to the State and to public or private entities.<sup>21</sup>

Under the Seychelles central bank law, central bank advances to the State are generally only allowed within the limits set by the Board of Directors of the central bank and to address “temporary deficiencies in revenue.” However, the central bank law also allows for a temporary waiver of those limits in emergencies, with robust procedural guarantees in the form of a report of the Ministry of Finance on the causes for the waiver, Presidential approval, and publication of the latter. Substantial safeguards also apply in terms of rates and compatibility with the monetary policy objective.<sup>22</sup>

When designing a central bank law provision allowing temporary monetary financing by a central bank, a number of specific legal design aspects should be considered. Specifically, the “escape clause” should:

1. be conditional upon the occurrence of a truly catastrophic event (war, pandemic, natural disaster) causing a severe funding market disruption
2. require a robust political procedure, requiring for instance the government and parliament to formally declare the occurrence of the catastrophic event

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<sup>20</sup> Noodwet Financieel Verkeer, Law of May 25, 1978, as modified by the Law of November 1, 2007.

<sup>21</sup> Article 27 paragraph 3 of the Organic Law of the Central Bank of Chile.

<sup>22</sup> Section 40A of the Central Bank of Seychelles Act.



3. establish the strictly temporary nature of the funding
4. ensure a proportionate degree of transparency on the funding
5. require the elaboration of an explicit formal framework (that is, a Memorandum of Understanding with the Ministry of Finance) setting the ceiling, repayment, and (market) interest rate for such temporary funding.

At any rate, the flexibility offered by such as “escape clause” may not be appropriate in all circumstances and may not be implemented in all countries. In countries with a high probability and history of abuse, a more stringent legal framework might be in order. Also, in regional monetary unions where the central bank law is enshrined in a treaty, this may require consent of all member countries.

## CENTRAL BANK FINANCIAL AUTONOMY NEEDS ALSO TO BE PROTECTED IN CASE OF SOLVENCY SUPPORT

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Despite massive policy support, crises like the current pandemic tend to cause financial distress with firms and households which eventually translates in deteriorating bank balance sheets. This would in turn require resolution of insolvent, non-viable banks. In some cases, “solvency support” to failing systemic financial institutions, or those whose financial soundness is uncertain, may be the preferred policy choice to maintain the stability of the financial system.

While solvency support is essentially a fiscal task, in many countries the central bank is likely to be called upon to finance such support. Solvency support must, however, be distinguished from the core central bank task to act as “lender of last resort” to the banking system.

The legal framework plays a central role in distinguishing central bank and fiscal roles. Few legal issues arise with respect to genuine “emergency liquidity assistance” to solvent banks.<sup>23</sup> However, the role for a central bank in providing solvency support (if any) should be underpinned by a legal framework that confirms the fiscal nature of such operations, thus safeguarding the central bank’s financial autonomy if it provides the initial financing.

Countries can undertake complementary legal steps in that regard.

- First, granting the State legal authority for solvency support, when and if required to maintain financial stability, avoids that the central bank assumes this task out of *legal* necessity. (Safeguards should avoid moral hazard, as set out in the *FSB Key Attributes of Effective Resolution Regimes of Financial Institutions*.<sup>24</sup>)

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<sup>23</sup> Almost all central bank laws authorize “emergency liquidity assistance” to banks explicitly or implicitly. Central bank laws with an explicit framework will typically constrain such emergency lending to temporarily illiquid but solvent banks. Several of those laws establish the temporary nature of the lending, and some of them also require a penalty rate. Central banks with an implicit framework can enshrine the same elements in an internal policy decision.

<sup>24</sup> To the same end, it is also important to establish a robust resolution framework, with well-defined roles for all relevant institutions, including the central bank and the State. Such a framework should, *inter alia*, contain provisions on the funding of systemic financial institutions in resolution, which could include the provision of liquidity support by a central bank under safeguards (as also set out in the *FSB Key Attributes of Effective Resolution Regimes of Financial Institutions*.)

- Second, if the central bank is required to fund solvency support operations, the legal framework or structure should clearly establish that this occurs on behalf of the State. In other words, the law should allocate the ultimate financial risk of such operations to the State.

As the State takes the ultimate risk, this is expected to require a political decision and possibly an instruction to the central bank—these steps are appropriate to safeguard the central bank’s financial autonomy and do not negatively impact monetary policy autonomy.<sup>25</sup> This approach has been followed by advanced economies (for example, the United Kingdom and the United States) and emerging market economies countries (for example, Malawi and Mauritania) alike.

## CONCLUSION

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Economic-financial crises typically tend to test the adequacy of central bank legal frameworks. The current COVID-19 pandemic is no exception. Many central banks have designed exceptional measures that seek to mitigate the blow of the pandemic. Of course, every central bank seeks to design measures that are authorized under current law.

But the crisis is also an opportunity to review the central bank’s legal framework. If the latter lacks the flexibility to support appropriate exceptional measures, consideration should be given to law reform, either in the short term to deal with the current crisis, or in the medium term to deal with the next one.

Ultimately, central bank laws need to strike a balance between flexibility and the mitigation of risks. This balance is not achieved in a vacuum but depends on the broader institutional quality and governance of the central bank. At any rate, a sufficiently broad “powers provision” that authorizes a wide gamma of generally appropriate financial transactions, combined with guided flexibility for the competent decision-making body, will go a long way in providing that flexibility. A well-designed “escape clause” allowing the central bank to provide—under specific conditions—funding to the government in severe emergency situations could also be useful, at least in the right context.

Beyond the central bank law, this note also highlights the importance of the legal design of the exceptional measures themselves. By ensuring the temporary nature of the measures, fair and clear access criteria, proportionate transparency and accountability, and where appropriate risk-bearing by the State, these legal design features can establish a sound legal framework that can help address reputational, financial, and legal risks for central banks, as well as safeguard their autonomy.

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<sup>25</sup> It is normal that distinct central bank functions are performed under different levels of institutional autonomy. See Bossu, W., S. Hagan, and H. Weenink. 2017. “Safeguarding Central Bank Autonomy: the role of transparency and accountability.” In *ECB Legal Conference 2017—Shaping a New Legal Order for Europe: A Tale of Crisis and Opportunities*, p. 36–37. While the monetary policy function must enjoy the highest levels of autonomy, other central bank functions might have lower levels. For some functions (fiscal agency, exchange controls, and solvency support), the State as principal can inherently instruct the central bank as its agent.